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Devaluation of the Chinese currency

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On 11 August China devalued its currency by 1.9% relative to the US Dollar and announced that in the future it would expose the exchange rate of the Renminbi to the forces of supply and demand on the foreign exchange market. In a press conference the Central Bank did say, however, that it would continue to intervene if the development of the Chinese currency were "volatile", "irrational", or "distorted".

More flexible exchange rate regime

From a technical point of view, the exchange rate regime has changed only marginally. The official pegging of the Chinese currency to the US Dollar was suspended in 2005, and a so-called managed exchange rate system was introduced. Since then, the exchange rate has been set daily on the basis of a currency basket (consisting of the US Dollar, the Japanese Yen, the British Pound, and the Korean Won). Over the years the daily bandwidth of the Yuan has been gradually expanded relative to the US Dollar to recently plus/minus one percent. Nowadays the Central Bank compiles quotations from large banks that are based on the closing rate of the previous trading day in order to set the daily rate. In doing so the Central Bank reserves the right to continue intervening if the fluctuations are excessive. Since Monday the Renminbi has fallen by 3% vis-à-vis the US dollar.

Transformation into a market economy

The measures represent a further important step towards a fully flexible exchange rate mechanism. This is part of the long-term transformation process of China, which contains a gradual shift from a planned economy to a market economy. The process will involve, among other things, the liberalisation of the financial system and the internationalisation of the currency.

Reserve currency Renminbi

China's policy is also geared towards the Chinese currency achieving the status of an official reserve currency. A fully flexible currency is the basic condition for being taken into the currency basket of the IMF for special drawing rights. The decision about this issue will be taken in autumn. A reserve currency should be stable in the long run in order to fulfil the value storage function of money. But it makes no sense to peg one reserve currency to another one.

Weakening economic growth

Chinese economic growth has been on a noticeable decline. The Chinese government is trying to stabilise this trend. Only last week it initiated a stimulus programme to the tune of 1.5% of GDP. Generally speaking, further supporting measures from the political front would fit the picture in this environment.

Robust currency

Since the beginning of 2005, the Renminbi has appreciated by about 50% relative to the currency basket mentioned above. It is also one of the few currencies that have joined the US Dollar on its way up since July 2014. This means that the Renminbi is one of the most robust currencies in the world. But with the increasing deterioration of the fundamental environment, the depreciation pressure has increased as well. The Chinese Central Bank, however, has issued the assurance that it is not interested in a prolonged depreciation of the currency and that the exchange rate was in line with the fundamental environment.

Emancipation from the US Fed

In view of the imminent start of the cautious interest rate hikes in the USA the Chinese Central Bank is emancipating itself from its US peer. A higher Fed funds rate in the USA has increased the pressure in China for rate hikes in order to maintain the exchange rate stable.

Pressure on Asian currencies

The pressure on other central banks, especially in the emerging markets in Asia, to cut the key-lending rates and/or devalue the currency will increase.

Adjustment in the emerging markets

The devaluation confirms the current environment in many emerging markets: falling export prices for goods, falling currencies, falling equity prices. This is due to a high, and drastically increased, level of debt in the private sector in many countries. At the same time both profitability and productivity have fallen. Adjustment is the consequence.

Goods from Asia become cheaper

As a result of the depreciation of the Chinese currency the pressure for prices to fall is being exported. Goods from Asia are becoming cheaper. This decreases the already low risk of inflation even further.

Overall we are taking a positive stance on the devaluation of the Chinese currency. The risk of a recession and deflation in China declines, and the structural reforms in China are making progress. But the step is also another sign of the fact that the boom in the emerging markets has made way for the adjustment to a changed environment. This also spills over into the developed economies: exports to the emerging markets are negatively affected, while imports are becoming cheaper.

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